No. 93-567

DEC 14 1993

In the Supreme Court of the United States

OCTOBER TERM, 1993

CONTINENTAL ILLINOIS CORPORATION, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

We demonstrated in our petition that the Seventh Circuit has decided a federal tax issue of great practical importance in a manner that conflicts with rulings of this Court in *Commissioner* v. *Indianapolis Power & Light Co.* and of the Second Circuit in *Ware* v. *Commissioner*. We showed as well that this conflict creates pervasive uncertainty for businesses that receive funds subject to an express agreement to repay. The decision below leaves those businesses in the dark about whether their tax obligations depend upon *Indianapolis Power's* precise legal standards for the identification of income or upon the exercise of unstructured agency discretion. The Commissioner's brief in opposition nowhere comes to grips with these arguments.

The Commissioner conspicuously does not dispute that the question presented is important. She does not deny that the Seventh Circuit's abandonment of *Indianapolis Power's* "complete dominion" test throws the tax treatment of myriad commercial transactions into confusion. She makes no attempt to respond to the examples cited in our petition (Pet. 20-21 & n.4), which demonstrate that the court of appeals' decision will adversely affect a broad variety of businesses that receive funds subject to a contractual obligation to repay.

Nor does the Commissioner deny that the ruling below creates particular uncertainty for the banking industry. As *amicus* American Bankers Association explains, the Seventh Circuit's decision is already having a "chilling impact" that impairs banks' "consideration of innovative financial products" involving a refund element. ABA Am. Br. 5-6. More basically, CAP loans like those at issue here are "widely offered throughout the commercial banking industry," "facilitate the pricing of loans," and "continue to be a very attractive financial product" for lenders and borrowers alike. *Id.* at 4-5. The Commissioner acknowledged the importance and

recurring nature of the question presented when she designated the non-recognition of excess interest on CAP loans as one of only five "coordinated issues" that IRS agents *must* challenge on audit of commercial banks. *Ibid.* That designation guarantees that banks across the country will routinely face challenges to their reporting of CAP loan receipts and that burdensome litigation on this issue will continue.

Remarkably, given the undisputed practical significance of the issue presented, the Commissioner makes no effort to show that the Seventh Circuit's decision is in harmony with *Indianapolis Power* and the long line of cases establishing that the "complete dominion" test determines "what sort of economic benefits qualify as income." 493 U.S. at 208-209. Instead, the Commissioner baldly asserts that the Court cannot have meant what it said in *Indianapolis Power* — a case the government lost only three years ago. Br. in Opp. 14-15. In its place, the Commissioner purports to rely upon two lines of authority that are transparently irrelevant because they concern the *time* when income or deductions are recognized, not *whether* a receipt is income at all. *Id.* at 7-13. Absent this Court's review, the IRS will reiterate these erroneous positions in countless future audits, multiplying the expense and burden of litigation for all concerned.

1. Applying the well-established test for income that asks whether the recipient has "complete dominion" over funds, this Court held in *Indianapolis Power* that "the crucial point is not whether [the taxpayer's] use of the funds is unconstrained during some interim period," but whether, "at the time the payments are made," the taxpayer "*has some guarantee that he will be allowed to keep the money.*" 493 U.S. at 210, 211 (emphasis added). Under that standard, IPL did not receive income when a customer deposited twice the amount of his monthly electricity bill "to insure prompt

payment" of utility charges, because IPL had a contractual obligation to refund the money unless the customer defaulted or requested that the deposit be applied to a future bill. *Id.* at 204, 211 n.7. In those circumstances, IPL had no guarantee when it received the funds that it could keep them; it had "an express 'obligation to repay'" the funds contingent only upon "events outside its control." *Id.* at 209, 214; see Pet. 10-11.

Under *Indianapolis Power's* unambiguous standards, excess interest received by Continental on its CAP loans did not constitute income. Continental lacked "unfettered 'dominion' over [excess interest] at the time of receipt" because it had no "guarantee" that it would be able to keep any of that money. 493 U.S. at 210, 212. The terms of Continental's CAP loans expressly obligated it to refund excess interest to the borrower at the expiration of the loan term, unless the borrower defaulted on the loan or prepaid its principal — contingencies that lay outside the bank's control. Pet. 3-4.[1] The Commissioner concedes that under the CAP loan agreements, at the time of receipt the "likelihood that the excess interest would have to be repaid" was "substantial" (Br. in Opp. 5); Continental in fact refunded virtually all excess interest during the years in issue (Pet. 4).

The Commissioner does not dispute that Continental had no guarantee that it could retain excess interest and so lacked

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[1] The Commissioner's assertion (at 15) that Continental is similarly situated to "employees [who] can be sued for the recovery of wages[,] shareholders [who] can be sued for the recovery of dividends[, or] merchants [who] can be sued for the recovery of money paid for sales" is thus deeply flawed. In none of those instances has the recipient of funds assumed an express obligation to repay them, as Continental did here.

"complete dominion." Br. in Opp. 2, 5. Instead, she resists review on the ground that *Indianapolis Power* is inapplicable. Relegating discussion of that case to the last few pages of her brief, the Commissioner portrays *Indianapolis Power* as a singular and isolated precedent concerning a narrow question whether IPL's receipts were taxable advance payments for service or non-taxable deposits. *Id.* at 13-14.

Through this revisionist interpretation the Commissioner effectively seeks to relitigate a decision in which this Court unanimously rejected her position. The Commissioner's interpretation conflicts with the plain language of *Indianapolis Power*, which states that the "complete dominion" test is a general one used to determine whether "payments constitute income when received." 493 U.S. at 211; see also *id.* at 208-209. And it ignores the fact that *Indianapolis Power* is only the most recent in a line of cases — which the Commissioner fails even to cite — in which this Court used the "complete dominion" test to determine whether receipts as varied as antitrust treble damages and embezzled funds constituted income. *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955); *James* v. *United States*, 366 U.S. 213 (1961). See Pet. 15-16 & n.3.

The Commissioner's alternative effort to escape the holding in *Indianapolis Power* is even more remarkable, for it depends on the naked assertion that this Court did not mean what it said in that case. Unhappy with *Indianapolis Power's* ruling that the "crucial point" in determining whether a receipt is income "is whether the taxpayer has some guarantee that he will be allowed to keep the money" (493 U.S. at 210) — a guarantee that Continental concededly did not have under the terms of its CAP loan agreements (Br. in Opp. 2, 5) — the Commissioner maintains that this formulation of the test for income cannot be taken "literal-

ly." *Id.* at 15. What this Court must have meant, the Commissioner contends, is that a taxpayer receives income when it has "some claim of right that *could* allow it to retain the funds." *Ibid.* (emphasis in original). And, the Commissioner asserts, her revised test for income was not satisfied in *Indianapolis Power* because IPL — unlike Continental — "had *an unconditional obligation* to repay" deposits and "thus lacked 'complete dominion' over them." *Ibid.* (emphasis added).

Not only is this rewriting of the test for income at odds with this Court's careful formulation of the "complete dominion" standard, but it is clear that under the Commissioner's test *Indianapolis Power would have been decided the other way*. IPL did *not* have an unconditional obligation to repay customers, but received the money under terms "that *could* allow it to retain the funds." IPL was not bound to refund customer payments if "the customer default[ed] or [requested that IPL] apply his refund to a future bill." 493 U.S. at 211 n.7. Pursuant to these terms, IPL "frequently" retained deposits. Br. in Opp. 14.

The Commissioner's unvarnished attempt to redraft *Indianapolis Power* cannot obscure the fact that this Court's decision conflicts squarely with the Seventh Circuit's ruling that excess interest that Continental was obligated to and did refund to customers was income to Continental upon receipt. Because the Commissioner's position is directly contrary to the precepts for identification of income laid down in *Indianapolis Power*, her determination that Continental did not properly account for income is not entitled to any "deference." See *United States* v. *Hughes Properties, Inc.*, 476 U.S. 593, 605-606 (1986) (rejecting IRS determination that an accounting method did not accurately reflect income where that determination conflicted with a prior decision of

this Court); *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 532-533 (1979) (courts should not defer to a "clearly unlawful" determination).

2. The Commissioner's convoluted efforts to distinguish the decision in *Ware* v. *Commissioner* also miss the mark. Br. in Opp. 16-17. As the Commissioner is forced to concede (at 17), the Second Circuit in *Ware* applied the *Indianapolis Power* "complete dominion" test to determine whether a fee charged by a law firm but held in escrow because of a dispute was properly includible in the firm's "income." It held that the fee was not income because the firm had no "guarantee" that it would be able to retain the money. 906 F.2d at 65. The court thus treated the standard for income identification set out in *Indianapolis Power* as a general rule of law and not — as the Seventh Circuit and the Commissioner would have it — as a narrow precept limited to customer deposits. Applying that standard, the Second Circuit would have decided this case differently.

3. The need for this Court's review is reinforced by the Commissioner's willingness to rely on irrelevant lines of authority in an effort to escape the clear rule for income identification laid down in *Indianapolis Power*.

a. The Commissioner first argues (at 7-11) that it is not *Indianapolis Power* that governs the identification of receipts as income, but the "all events" test. Under that test, "gross income for the taxable year includes all items *of income* for which (i) all events have occurred that fix the right to receive *the income* and (ii) the amount of *that income* can be determined with reasonable accuracy." Br. in Opp. 7 (emphasis added). Likewise, a taxpayer may deduct a business expense only when "'all events' ha[ve] occurred to fix the liability." *Id.* at 8. See 26 C.F.R. § 1.446-1(c)(1)-(ii). The "all events" test, however, has no bearing on the

question whether excess interest was income to Continental. That test governs *when* a taxpayer must recognize income, not *whether* a receipt is income at all; it explicitly presupposes that the taxpayer has an item of income.

The Commissioner cannot point to a single case in which this Court has used the "all events" test to determine *whether* a receipt of funds was income. Instead, the Commissioner cites (at 7-11) a series of decisions that apply the "all events" test to determine *when* a deduction may be taken because the expense has become fixed and its amount reasonably determinable. See *United States* v. *General Dynamics Corp.*, 481 U.S. 239 (1987) (employer could not take a deduction for the estimated cost of employees' benefit claims; its liability was not fixed until employees filed their claims in a later year); *Hughes Properties*, 476 U.S. at 601 (casino could deduct payouts required by state law even though the payouts had yet to be made and there was a "remote and speculative possibility" that they would never occur); *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182 (1934) (company could deduct uncollected receivables when it could be determined that they were uncollectible). Continental's claim is that excess interest was not income at all under the rule in *Indianapolis Power*, and does not involve the timing of any deduction from income. Thus, the Commissioner's authorities are not remotely relevant; nor did the Seventh Circuit decide this case by applying the "all events" test.

The Commissioner's heavy reliance on another case concerning the timing of deductions, *Brown* v. *Helvering*, 291 U.S. 193 (1934), is equally mysterious. Br. in Opp. 8-10. In *Brown*, an insurance agent received commissions on the sale of policies "under no restriction, contractual or otherwise," and those commissions were not disputed to be "gross income of the year in which they were receivable."

291 U.S. at 199. The agent nevertheless tried to take a deduction in the year of receipt to reflect its speculative estimate of commissions it would return if policies were cancelled in later years. This Court disallowed the deduction because the agent's liability was not yet fixed. *Id.* at 201.

Brown is far removed from Continental's case. The Commissioner agrees that Continental's previously existing contracts with each borrower laid down a precise formula that distinguished the floating interest rate from the fixed cap rate. Br. in Opp. 2-4; see Pet. 3-4. Those contracts stipulated in advance of each interest payment that, in ordinary circumstances, the amount above the cap would be returned to the borrower. And when an interest payment was received, it was immediately determinable that a specific part of the payment would have to be accounted for as interest "collected but not earned." *Ibid.* It was not a future contingency, like policy cancellations in *Brown*, that led to this classification of Continental's receipts, but the previously negotiated loan agreement and the "fixed" economic fact that the interest Continental collected at the floating rate exceeded the capped amount by a specific sum.

b. The Commissioner also argues (at 11) "that petitioner is not entitled to a current deduction [under] the 'claim of right' doctrine described in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424 (1932)." This contention is multiply flawed. To begin with, Continental disputes not when a deduction or item of income accrues, but whether excess interest was income at all. The Commissioner's assertion (at 12) that this distinction "does not matter" is belied by the rejection in *Indianapolis Power* of a similar argument that the "claim of right" doctrine governs the identification of income (Commissioner's Opening Br. at 13 n.5, *Indianapolis Power*, No. 88-1319), and by this Court's

application instead of the "complete dominion" standard. It is inconsistent, moreover, with the Solicitor General's concession in *James* that the "claim of right" doctrine is invoked "to determine *when*, not *whether*, receipts constituted income." 366 U.S. at 216 n.7. See also *Healy* v. *Commissioner*, 345 U.S. 278, 281 (1953) (the doctrine determines whether a taxpayer may defer recognition of "an amount otherwise includible in income"); Dubroff, *The Claim of Right Doctrine*, 40 Tax L. Rev. 729, 736-737 (1985) (the doctrine is "based upon the assumption that the funds held by the taxpayer have the character of income").

Beyond this, *North American Oil* favors Continental, not the Commissioner. In that case, the United States disputed North American's right to profits from certain oil wells and appointed a receiver to hold those profits, which North American consequently did not report as income. 286 U.S. at 420-421. Profits for 1916 were paid to the company in 1917 by the receiver, after a court ruled the company entitled to them; the Commissioner then assessed a tax deficiency for 1916. This Court disallowed the deficiency determination, "[f]or the company was not required in 1916 to report as income an amount which it might never receive. * * * Throughout 1916 it was uncertain who would be declared entitled to the profits." *Id.* at 423. Here, Continental received excess interest on terms that required it to refund the money except in unusual circumstances where the borrower defaulted or prepaid the loan. It had no "claim of right" to excess interest at the time of receipt; the governing loan agreements provided for a refund. If there was no income in *North American Oil* while it remained "uncertain who would be declared entitled to the profits," then *a fortiori* excess interest was not income to Continental upon receipt

when it was all but certain that the bank would have to refund it.[2]

The undisputed importance of the question presented, the manifest conflict with *Indianapolis Power* and *Ware*, and the Commissioner's confusion over which of this Court's precedents govern the identification of income all demonstrate the need for immediate review.

CONCLUSION

The petition for a writ of certiorari should be granted.

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[2] Amazingly, the Commissioner seeks to defend the Seventh Circuit's judgment by quoting (at 12-13) out-of-context snippets from two "claim of right" decisions of the same court, both of which predate *Indianapolis Power*. But in *Illinois Power Co.* v. *Commissioner*, 792 F.2d 683, 689-690 (7th Cir. 1986), the court held that receipts were *not* income when the taxpayer had an obligation to repay the funds and, as here, "the likelihood [of repayment] was * * * great." In *American Medical Ass'n* v. *United States*, 887 F.2d 760, 774-775 (7th Cir. 1989), the AMA unsuccessfully attempted to defer recognition of a portion of membership dues set aside to cover speculative future operating deficits. In contrast to Continental's case, those funds were not received subject to a preexisting obligation to repay.

Respectfully submitted.

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